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**Non-Par Banking: Competition
and Monopoly in Markets
for Payments Services**

by Ed Stevens



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Competition and Monopoly in Markets for Payments Services**

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Non-Par Banking
Competition and Monopoly in Markets for Payments Services

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Abstract

Much of the literature treats the existence of non-par banking as a legal matter, emphasizing the Board of Governors' legal struggle to force non-par banks to pay Reserve banks at par. This treatment is not satisfactory. In competitive markets, par paying banks should have been able to undercut non par banks' prices, once the Reserve banks had eliminated exchange charges by integrating their balance sheets. More likely, the survival of non-par banking reflected the absence of competition in the markets in which non-par banks operated. Past empirical evidence is consistent with this conclusion: non-par banks typically were monopolists in isolated rural markets for banking services.

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Introduction

A common perception is that the provision of payments services by the Federal Reserve banks provides a regulating role in payments systems markets. (Gilbert 1998)

Historically, Federal Reserve bank check collection service is said to have been a critical element in the emergence, prevalence, and eventual dominance of par check collection in the United States. The purpose of this paper is to review that example, investigating the influence of the Federal Reserve System in the gradual elimination of non-par banking.

Past studies of non-par banking have been of two kinds, neither of which is wholly satisfactory. Many have viewed the Reserve banks as engaged in a check collection battle that, were it not for legal and political constraints, would have eradicated non-par banking in short order. (Tippetts 1929; Wyatt 1944) Others have taken a more dispassionate view, investigating how the market characteristics of non-par banks were consistent with a protracted decline of non-par banking. (Jessup 1967; Krebs 1959) The present paper takes a different tack, arguing that non-par banking would have disappeared even if the Reserve banks never had entered the check collection business. The crucial innovation of the Federal Reserve that eventually ended non-par banking was its elimination of exchange charges, not its entrance into the check collection business.

The argument of this paper depends on an understanding of payments institutions in the United States prior to the Federal Reserve. In particular, the terms 'exchange charge' and 'remittance fee' have come to be used almost interchangeably in discussions of non-par banking. This confuses two distinctly different kinds of interbank money transfers, a confusion to be avoided in what follows. In today's world these two kinds of payment might be distinguished as settling for individual wholesale payments, typically made over the Fedwire and CHIPS networks, and settling for retail payments, typically made by cash letters representing one or more check or ACH payments.

Prior to the introduction of the Federal Reserve System in 1914, wholesale payments passed through the market for exchange. They involved drafts or telegraphic instructions transferring respondent banks' deposits at their correspondent banks in major financial centers, particularly New York City. A major difference from today's payments

is that those wholesale payments typically involved an 'exchange charge,' independent of charges for time value, credit risk, and delivery. An exchange charge was a discount or premium per dollar at which balances in a distant bank were made available locally.

Retail payments also involved interbank transfers, when collecting items drawn on other banks. Banks that remitted less to collecting banks than the face, or par, value of their customers' checks were called non-par banks. The small percentage of the payment deducted by non-par banks was called a remittance fee. Originally, in the case of checks, a per-dollar 'remittance fee' might have reimbursed a paying bank for the exchange charges incurred when remitting to a distant collecting bank. Exchange charges had disappeared completely within five years of the opening of the Federal Reserve banks in late 1914. Remittance fees, however, lingered for another sixty years at some banks, despite the determined opposition of the Federal Reserve. Their last traces did not disappear until 1980.

The remainder of this paper is in five parts, beginning with a brief analysis of the nature of exchange charges and the role of the Federal Reserve banks in eliminating them. This is followed by a similar discussion of remittance fees, the distinguishing feature of non-par banking. The third section summarizes the Board's attempt to stamp-out remittance fees and the fourth investigates the seeming anomaly of the persistence of remittance fees despite the disappearance of exchange charges. A final section summarizes the findings and suggests implications for the future. To anticipate the findings, remittance fees, 'though perhaps initially arising from exchange charges, simply became a convenient way for a limited set of banks to extract monopoly rents where competition was lacking. For the future, as long as the Reserve banks provide a means of par interbank settlement to providers of payments services in competitive markets, modern analogues of non-par banking seem unlikely to prevail. Also, non-par banking provides a warning to public agencies about seeking self-defined social reform through market participation. If the reform is not in the legislative mandate of the agency, the courts may be even more decisive than competitors in terminating the effort.

Exchange Charges

Prior to the opening of the Federal Reserve banks, exchange charges had created a matrix of discounts and premiums on the exchange of bank deposits among banks in different regions. These charges varied over both place and time, reflecting the cost of settling regional interbank payments imbalances with reasonable finality (Garbade and Silver [1979]; Phillips and Cutler [1997]). The classical gold standard provides a good analog for understanding the determination of exchange charges. In that international monetary regime, the exchange rate between US dollars and British pounds, for example, while anchored by their respective gold parities, varied within a range set by 'gold points.' The dollar price of the pound might rise in response to an excess supply of dollars held by those seeking to make payments in pounds, but the price rise was limited. Once the exchange rate exceeded the value of pounds implied by the two gold parities plus the cost of shipping gold from one nation to the other, gold would flow and bring the price down to that upper limit.¹

A similar arbitrage mechanism operated internally in the United States before 1914 when national bank notes and coin and currency were the form of riskless non deposit money available as an alternative to bank checks and drafts for making interbank payments nationwide. An excess supply of deposits in local banks held by those seeking to make payments in other regions of the country would drive up the price of 'exchange,' that is, the premium local banks charged to exchange local deposits for dollar deposits in correspondent banks in New York City or other major financial centers. This premium was limited, however, by the cost of shipping coin and currency to the other regions. Paying a premium for 'foreign' deposits made no economic sense if it was cheaper to ship coin and currency instead.

Likewise, an excess demand for local banks' deposits on the part of those holding deposits elsewhere, but seeking to make local payments, would drive down to a discount the local value of 'exchange' in the form of deposit balances at correspondent banks in

¹ A large literature has developed around the operation of the classical gold standard, concerned with the accuracy of this description, the efficiency with which the process worked, and the data with which to

New York City or other major financial centers. This discount on exchange also was limited by the cost of shipping coin and currency into the region whose bank deposits were in excess demand. Accepting the discount on 'foreign' deposits made no economic sense for those making payments into the region if it was cheaper to ship coin and currency.

Exchange charges were common prior to the operation of the Federal Reserve System. Prevailing charges were quoted in daily newspapers, and, in general, varied seasonally. They also trended downward over the latter years of the Nineteenth Century. Declining costs of transportation and other technological changes narrowed the range within which charges could vary without triggering shipments of coin and currency (Phillips and Swamy [1997]).

The Federal Reserve Act was designed to change all this. The Federal Reserve banks issued a new form of money that banks could use to pay one another without any economic basis for exchange charges. Even the earliest drafts of the Act included provisions for an interbank payment mechanism without exchange charges, although they had no provision for the Reserve banks to operate a check collection service. The first draft of the House bill, for example, only obliged Reserve banks to accept, "at par, and without charge for exchange," interbank checks and drafts written *by member banks on other member banks* and Reserve banks. (Stevens [1996]).

The Federal Reserve Act, both as originally envisioned and as finally instituted, gave member banks the ability to pay one another simply by transferring their Reserve bank deposits among themselves. Member Banks began making interbank transfers of the new Federal Reserve money when the Reserve banks opened for business on November 16, 1914. Within two days, Boston banks were using checks drawn on their reserve accounts to settle their daily positions at the Boston clearinghouse. This was almost eight months before all of the twelve Banks began to offer nationwide check collection service for member banks.

observe the process. A recent statement of issues, with an extension of empirical investigation through the use of daily data can be found in Prakash and Taylor (1997).

Reserve banks accepted deposits at par, but this alone would not have eliminated exchange charges, for two reasons. One was float. Transfers of reserve balances were made by paper checks and drafts, or by telegraph. Processing and transportation of paper took time, creating a potential basis for float-related exchange charges even though, at the outset, checks received immediate credit when deposited.² Moves to account for the influence of transportation soon began. By May 1915, the New York Bank was offering to transfer reserve funds nationwide at no charge if the payee was advised by mail. Telegram advice was available, however, if the payor was willing to pay 2% at an annual rate of the amount transferred for the number of days saved relative to a mail advice. Eighteen months later, this charge was dropped. Inter member bank transfers with telegram advice became free, other than for the cost of the telegram.

The initial practice of granting immediate credit (and debit) for checks deposited in a Reserve bank's check collection service gave way to deferred debits and credits in 1917. This would not have added float to interbank payments, however, for the Reserve banks offered transfer drafts for this purpose. These drafts were payable at any Reserve bank in immediately available funds. Finally, in 1918, member banks began to use the System's new leased telegraph wire to make same day interbank transfers of funds nationwide, eliminating any basis for exchange charges related to float in funds transfers.

Immediate, same day interbank transfers of reserve deposits were an efficient mechanism for reducing exchange charges, but could not remove the regional imbalances in payments that were the ultimate economic basis for exchange charges. After all, Congress had created not one, but twelve independent bankers' banks serving non-overlapping Districts within the nation. Regional imbalances of payments would show up as changes in banks' reserve deposits and inter-Reserve bank claims. Net inflows or outflows of funds still might accumulate within a District. All else equal, two results would be expected. One is the development of a market in exchange, just as before 1914. The other is that the Reserve banks would adjust their lending rates relative to one

² The Reserve banks began charging fees averaging 1.34 cents per item for check collection service in 1915. These per item fees were not comparable to exchange charges, which were discounts or premiums *per dollar*. In any case, the fees were eliminated on July 1, 1918, until re-instituted by the Monetary Control Act of 1980.

another, to attract or repel borrowing that would counteract regional imbalances in payments flows.

But all else was not equal. The initial legislative design had been for the Board to create an interdistrict clearinghouse. The result was the Gold Settlement Fund, which employed multilateral netting of inter-Reserve bank claims to eliminate some of the need for costly shipments of Federal Reserve notes or coin. Moreover, the initial design included two methods of reallocating funds among Districts: Managing the distribution of Treasury deposits among the Reserve banks, as well as directing Reserve banks to rediscount the paper of other Reserve banks. The power to allocate Treasury deposits did not survive the legislative process, but both the clearinghouse and the forced rediscounting (with the affirmative vote of five members of the Federal Reserve Board) features survived in the final version of the Act.

The Settlement Fund was introduced in May, 1915, but the governors of the Reserve banks already had discovered the effect of imbalances in inter District flows of funds.³ In December 1914, only a month after the Banks opened for business, the governors had decided:

...to continue for a few months the practice of receiving at par checks on Federal Reserve banks in order to observe the results of facilitating in this way the transfer of money between the 12 Federal Reserve cities. Member banks in debtor districts promptly took advantage of it to make exchange without cost on points in creditor districts. The result was that the Federal Reserve banks in debtor districts soon found themselves owing large sums to Reserve banks in creditor districts. In order to prevent the further accumulation of such balances and avoid a heavy burden of expense, Reserve banks in debtor districts charged member banks drawing such checks with exchange thereon at the current rate for exchange on the points to which they were sent. This had the effect of restraining the process and the transfer of funds soon returned to its normal level (Annual Report of the Federal Reserve bank of New York, in Board *Annual Report* [1915], p. 157).

Multilateral netting did not ensure balanced availability of reserves as long as some Districts ran persistent multilateral net outflows, matched by multilateral net inflows of others.

³ 'Governor' was the title of the chief executive officer of a Reserve bank until the Banking Act of 1935 changed it to the current more conventional 'President.'

The decisive feature that could eliminate exchange charges, found in the earliest draft as well as in the final version of the Act, was the Board's power to manipulate the relative size of the reserve base of each Reserve bank. The Reserve banks could offset multilateral inflows and outflows by rediscounting among themselves voluntarily. However, if they didn't, the Act empowered the Board to force rediscounting. This provision appears to have been well advised, for the Reserve banks seem to have had little appreciation of their power to eliminate domestic exchange charges, at least initially. According to the Federal Reserve Bank of Minneapolis, for example,

The demand for eastern exchange in this district is so steady that for the greater part of the year a premium is paid. For a period of from two to three months, during crop-moving time, Chicago and eastern funds go to a substantial discount. It was therefore considered desirable by the officers of this institution to accumulate funds for the use of member banks when the turn came. This was done by the acceptance of eastern exchange at a discount based on the cost of shipping mixed currency to or from the nearest sub treasury. These accumulated funds will be sold on the same basis.

It is believed that the policy of establishing a flat rate is sound and desirable and that the building up of balances in the East at a fixed discount rate and the sale of these balances at a fixed premium will do much to prevent violent rate fluctuations (in *Board Annual Report* [1915], p. 325).

At least through the end of 1915, the Reserve banks apparently did not comprehend their own power to stabilize the distribution of base money. Rather than using inter District clearing and rediscounting to that end, they instead operated as twelve independent central banks, each using its inventories of 'foreign' currencies to stabilize its domestic exchange rate within the bands set by the cost of shipping federal cash. To some extent, however, this lack of understanding may have been more academic than real: The New York Reserve bank admitted that in 1915, "outside of the [relatively few] banks that have joined the collection system and whose accounts are therefore active, only about 36 banks draw on their accounts from time to time. The accounts of the other 410 banks remain practically dormant" (Board, *Annual Report* [1915], p.155).

Account inactivity and, as will be indicated below, the unpopularity of the initial Reserve bank check collection service do not seem altogether surprising, for at this early stage in the development of the System, required reserves were not yet consolidated into

accounts at the Reserve banks. Many banks could still use correspondent balances both to satisfy the new Federal Reserve System reserve requirements and to continue to use correspondents for clearing checks and other services.⁴

The Federal Reserve Board, however, understood the powers it was given. For example, the Board reported in 1915 that:

...it was fully prepared to set in operation, if it should become necessary...the machinery of interbank discounting, in order to make available for Federal Reserve banks requiring larger resources the available funds of other Reserve banks, the collective strength of the reserve system as a whole being far in excess of any demands that might reasonably be expected to be brought to bear upon it at that time. (Board Annual Report [1915], p. 8)

And in 1917, that:

The Board has, from time to time, advised the purchases of acceptances by Federal Reserve banks from each other, and on two occasions during the year has exercised its powers of requiring Federal Reserve banks to make rediscounts for other Federal Reserve banks as provided in section 11 of the Act.

It is the policy of the Board to maintain an approximately uniform reserve position for all of the Federal Reserve banks and to correct wherever necessary, by means of interbank rediscounts, the inequalities which result from seasonal movements of trade or, more particularly, from the operations of Government financing. (Board Annual Report [1917] p. 29)⁵

Regardless of any initial confusion on the part of the Reserve banks, experience soon demonstrated that the new Federal Reserve System in fact had eliminated domestic exchange rates. By 1920, newspapers ceased reporting domestic exchange rates, some

⁴ The Federal Reserve Act permitted country and reserve city banks to maintain 5/12ths and 6/15ths, respectively, of required reserves as deposits in national banks in reserve or central reserve cities for the first year of the System's operation, rather than as vault cash or Reserve bank deposits. These two proportions were scheduled to decline at 6-month intervals to zero in November, 1917. Amendments to the Act cut the scheduled process short, however, bringing the permissible proportion of reserves held in national banks to zero in June, 1917.

⁵ Today, rather than these original ad hoc adjustments, the System follows a routine procedure for offsetting a District's reserve gain or loss from persistent surpluses or deficits in its balance of payments. Annually, an amount equal to a Reserve bank's settlement gain or loss for the year is removed from its settlement position and added to its gold position. Then, each Reserve bank's gold position relative to its note liabilities is restored to the System average ratio of gold to note liabilities, by an offsetting adjustment to its holdings in the System Open Market Account. The banks' resulting shares in the System Open Market Account are the basis for allocating System Account transactions in securities among the twelve banks for the ensuing year. (Financial Accounting Manual for Federal Reserve banks, January 1997)

time after reported rates had settled at par. (Gilbert [1997], p. 41; Garbade and Silver [1979], p. 15)

Remittance Fees and Non Par Banking

The mechanics of non par banking were these: When the proceeds of a check were collected from a non par bank (other than over the counter during business hours, or through an organized clearinghouse, or under the terms of a bilateral agreement to waive the fee), the paying bank deducted a remittance fee from the face value of the check in determining how much to pay the collecting bank. This deduction from par was in addition to the processing and transportation costs the collecting bank incurred to present the check for collection.

At the time the Federal Reserve banks opened, the incidence of remittance fees varied widely across the nation. In New England, almost all checks that were drawn on and collected by New England banks were paid at par.⁶ In other places, local checks typically were collected at par, as were those drawn on banks in nearby financial centers. Where par remittance was not the case, remittance fees sometimes were fixed by clearing house agreements, but otherwise were set at the discretion of the remitting bank. The level of remittance fees, where they were above zero, appears to have ranged from as low as one twentieth of one percent up to three tenths of one percent. (Board Annual Report [1915])

The common rationale for non-par payment of depositors' checks was that remittance fees compensated the paying bank for the cost of providing funds to the collecting bank at a distant point. That is, the fees were made necessary by the exchange charges local banks paid to acquire funds acceptable to distant collecting banks, including the cost of maintaining a deposit balance with a distant correspondent, on which the earnings rate was low.

⁶ Apparently it was not true that all checks drawn on New England banks were collected at par in New England, although this is the impression many writers have given.. The Boston Reserve bank, in reporting on the introduction of nationwide service to collect checks from all banks willing to remit at par, notes that 85 New England banks had been unwilling to remit at par to the foreign department of the Boston Clearing House. When the Reserve bank took on this collection service, "the banks that had refused to waive exchange charges to the Boston Clearing House Association all agreed to remit for their checks at par."

Elimination of exchange charges by the introduction of the new Federal Reserve money should have been expected to eliminate non-par banking in a competitive banking system. After 1918, at least, all member and some non member banks could remit funds for checks presented to them from anywhere in the nation without cost by using their reserve and clearing accounts at Reserve banks. Competition among correspondent banks for the business of all other non-member respondents should have spread this change in cost across the entire banking system. Payees, presumably pleased with the experience of par collection of some items, might have refused to accept payments from customers of non-par banks. Payors, as a result, might have deserted non-par banks, forcing them either to go out of business or to convert to par remittance. Or, if non par items continued to be accepted, the same result might have been achieved if the extra costs of collecting non par checks were passed-through to payees and their non par banks, whether as sour looks or extra charges.

Viewed against this model of the diffusion of technological change in competitive markets, two major questions beg to be answered. One is why the Federal Reserve Board did not rely on the elimination of exchange charges to eliminate remittance fees through competitive forces, as far as those forces were effective, and live with the residual non-par banks where competition was not effective. Instead, the Board waged—but lost—a decade-long battle to force every single bank in the nation to stop charging remittance fees. The Board's ammunition in this war included successfully championing amendments to the Act, allowing Reserve banks to employ banking practices that were termed "embarrassing, annoying and expensive to the bank against which they were directed," and actively engaging in litigation that reached the United States Supreme Court in more than one case (Spahr [1926], p. 238). The other question is why non-par banking persisted for more than sixty years after the Federal Reserve System began operations. The Reserve banks, in effect, ensured universal par payment at the interbank, wholesale level after 1918, but it was not until December 31, 1980 that the Board could report that there were no non-par banking offices. (Board Annual Report [1980], p. 281)

The Federal Reserve Board Campaign for Par Banking

The Federal Reserve Act gave the Reserve banks a franchise to conduct a correspondent banking business, collecting checks and non cash items for, and lending to, member banks.⁷ The apparent reason for including this feature in the Act was to “glue” commercial banks to the new Federal Reserve System by making required reserve balances useful in the everyday business of banking. (Stevens [1996]) As the Federal Reserve Agent’s Committee on Clearings later explained, “... the daily depositing of checks and drawing of drafts will foster a close and normal relationship between the Reserve bank and its members and will be constant evidence both to them and to the public that the system is doing something for them; nor will the effect of this be lost on the State banks.” (Monthly Bulletin [September 1915], p. 370) Reserve accounts would provide deposit balances from which checks could be paid when presented and into which the proceeds of collected checks could be paid.

The Reserve banks’ potential correspondent banking clientele was limited, however. The Act allowed Reserve banks to provide check collection service, but only at par and only among their member banks. This meant that members could deposit for collection only checks drawn on other member banks or Federal Reserve banks. While all national banks had to be members, many apparently were not keen on their new situation. State banks could join or not as they chose, and relatively few so chose. Checks drawn on non members presumably would have to be collected through local clearinghouses and competing correspondent banks, or through Reserve banks as non cash collection items for credit only when payment was received.

From the outset, the Federal Reserve Board seemed determined to achieve a larger role for the Reserve banks and for their check collection function than was suggested by

⁷ This feature appeared half way through the yearlong legislative process. A separate clearinghouse provision of the Act was in the initial House version, but its significance seems slight, if by clearinghouse one means “an offsetting of claims, leaving only the net differences to be paid in some satisfactory manner.” (Spahr 1926, p. 68) Congress did not *direct* the Reserve banks to operate clearinghouses, but merely indicated that the Board “may also require each [Reserve bank] to exercise the functions of a clearing house for its member banks.” (Section 16, para. 14) Whether any Reserve bank ever has operated a clearinghouse is not clear, in the sense of offsetting claims to achieve a multilateral net settlement. Instead, the Reserve banks operate a gross settlement system, collecting the total amount each bank owes for items presented, and paying the gross amount due to each bank for the items deposited.

the limiting language of the 1913 Act. The Board's apparent objective was for Reserve banks to take over the correspondent banking business, at least for member banks, by operating a universal check collection service—that is, a service that could collect a check drawn on any bank in the United States.

“After November 16, 1917, no bank balances will be available as reserve for national banks except balances in Federal Reserve banks, and therefore after that time any necessity to maintain non reserve balances with correspondents, either for exchange purposes or in order to obtain collection facilities, would be deemed in many cases a great hardship. ... A system that will enable them to send all of their checks on other banks to the Federal Reserve banks for exchange purposes or as an offset against checks on themselves forwarded by the Federal Reserve bank, will, in the course of time, come to be appreciated as a convenience. (Monthly Bulletin [June 1916], p.263)

The Board saw that,

...the Act in effect establishes 12 focal points at which all checks can be centered and collected, and it is fully expected thereby to create a more efficient machine for check collections than has ever existed in the country before. (Monthly Bulletin [June 1916], p.311)

The Board initiated a uniform collection system within each of the twelve Reserve districts in early March 1915. The collection plan was voluntary in that the Reserve banks would collect only those checks drawn on members who would voluntarily remit at par. The Banks could collect checks drawn on non-members, but not as cash items for immediate credit.

The initial hope had been that “a very large number of member banks would promptly affiliate themselves with the new ... system of clearing and that the natural force of economic competition would ultimately attract to it those who at first might hesitate,” but this hope was “severely disappointed” by the results of the first half year's operation of the Reserve banks' limited check collection system, and by the “failure of jobbers and merchants to appreciate the advantages” of par remittance and insist “that their own banks join and cooperate in the plan.” (Board Annual Report [1915])

May of 1916 brought a revised plan, implemented in mid July. This time, the Board mandated that all member banks remit to the Reserve banks at par, either from their reserve accounts or by shipping—at the expense of the Reserve bank—lawful

money or federal Reserve Notes. And, items drawn on non members would be accepted on the same terms as those drawn on members, as long as the non member paying bank agreed to remit at par. To assist in distinguishing par from non-par non-members, the Board began to maintain and publish a list of banks from which they would collect at par.

To buttress it's treatment of non members' items, the Board successfully sponsored legislation that, effective in September 1916, changed the language of the Act from "receive ... checks, and drafts upon solvent member banks" to "receive ... checks, and drafts." Governor Harding later reported that, once again, "...some members of the Board were optimistic enough to believe that in a short time checks drawn upon practically all banks in the United States could be collected at par by the Federal Reserve banks, upon the theory that a bank would be likely to lose desirable business when checks drawn upon it would be at a discount outside of its own neighborhood, while checks drawn on a near-by competitor would be taken at par." (Harding [1925], p. 53)

Within a few months, convinced that they had not done enough, the Board proposed further amendments to the Federal Reserve Act, submitted in December 1916. These were designed with three objectives in mind. One was to facilitate war finance, another was to make membership more attractive to state chartered banks, and a third was to expand the Reserve banks' check collection business by allowing them to collect checks not only from, but also *for* non members who would maintain clearing balances.

One of the Governors argued at the time,

"The collection system is not yet complete, as the Federal Reserve banks do not handle checks on all State banks and trust companies, although the total number of banks on their lists now aggregates more than 15,000. The Board has, however, formulated a plan which is dependent somewhat on upon the effect of a proposed amendment which it has transmitted to the Committee on Banking and Currency in the Senate and House, which will enable the Federal Reserve banks to collect checks drawn upon any bank or trust company in the United States...(Monthly Bulletin [February, 1917], p. 80)

The Board itself explained that,

“...any clearing and collection plan to be effective must be so comprehensive as to include all checks. At present the par lists of the Federal Reserve banks include the names of banks checks on which can be collected in any circumstances at a minimum of time and expense, but do not embrace a large number of towns in every State where there are no member banks; and in order to make collections on such points many banks are obliged to maintain accounts in addition to their reserve accounts with the Federal Reserve banks. A necessary factor in any successful clearing plan is the offset, whereby balances only require settlement instead of the total volume of transactions. As long as the clearing system does not embrace all of the banks this offset is lost in a corresponding degree and the value of the system diminished in proportion.” (Monthly Bulletin [February 1917], p.100)

The resulting legislation of June 1917 gave the Reserve banks explicit authority to maintain clearing accounts for *non members* who would agree to maintain balances adequate to remit at par for items presented by a Reserve bank. Why non-members? As later explained by the Board’s Chief Counsel, “[i]t was thought that, if these banks could send checks to the Federal Reserve banks for collection, they would more readily remit for checks drawn upon themselves and sent to them by the Federal Reserve banks and that thus the check collection facilities of the Federal Reserve System would be broadened greatly. It was believed that this not only would increase the usefulness of the Federal Reserve System to the general business of the country but also would facilitate the sale of war bonds and the handling of innumerable financial transactions incident to the war.” (Wyatt, 1944, p. 373) The Board itself emphasized that this was to “permit non member state banks and trust companies even though too small to be eligible for membership in the Federal Reserve banks, to avail themselves of the clearing and collection function ...” and “for the convenience of the public and incidentally for the benefit of member banks.” (Monthly Bulletin [December 1916])

The Board’s proposal to allow non-member access to the Reserve banks’ check collection system apparently was not controversial, but the accompanying requirement that nonmembers remit at par reopened one of the legislative battles of 1913. Senator Hardwicke successfully added an amendment that allowed all banks to impose exchange charges and remittance fees of up to 10¢ per \$100. Board opposition was unsuccessful in blocking this provision and barely succeeded—with the aid of an appeal from President Wilson to avoid destroying “the function of the Federal Reserve banks as a clearing house

for member banks"—in adding the provision that “no such charges shall be made against the Federal Reserve banks.

The 1917 amendments allowed non-members of any size to use the clearing and collection function, but also included important features making membership more attractive for State banks, particularly a shift of supervisory responsibility for state member banks from the Comptroller to the Reserve banks. Applications for membership began to increase, but it’s difficult to say whether this was the result of the legislation or of an impassioned appeal by Woodrow Wilson, urging membership as evidence of patriotism in time of war. The Board sent his appeal to all banks, dated one week after passage of the Trading With the Enemy Act, reiterating that “membership in the Federal Reserve System is a distinct and significant evidence of patriotism.” (Monthly Bulletin [November 1917], p. 827-8)

Despite the 1916 and 1917 amendments, however, non-members did not flock to open clearing accounts and use the Reserve banks to collect their checks. The remaining impediment to universal par check collection service was that more than ten thousand non member state banks still refused to remit to Reserve banks at par. The Board had outlined a solution to this impediment early in 1917: The Reserve banks would present checks to non par banks over the counter, where the banks had a legal obligation to pay at par. In this way, even the recalcitrant could be added to the par lists. The Reserve banks would be able to collect at par from any bank, assisted by a convenient decision to stop charging explicit fees for service.

The strategy behind these tactics seems to represent a significant shift in the focus of the Board’s campaign to develop a universal par collection system, confusing the ends with the means of its check collection policy. Prior to this, the Board had been seeking to placate national banks and to attract state banks to membership. Developing a universal par check collection system would appeal to the self-interest of actual and potential member banks. The more universal the set of banks from which the Reserve banks could collect checks, the more attractive would membership become. In reacting to the Hardwicke amendment of 1917, however, the Board reversed its apparent priorities.

Thereafter, the Board sought to draw all banks into a member or non-member deposit relationship with the Reserve banks in order to perfect the check collection system.⁸

Elevation of a universal par collection service to the position of an over-riding goal seems to have had two related roots. One was the concept of “perfection” in the clearing and settlement of payments. By analogy to a true net settlement clearing house, the more comprehensive the coverage of the collection service, the smaller would be the likely net debit and credit positions of the banks through whom the transactions took place. Because multilateral clearing allows settlement by offset, the implication was that the more widespread the clearing, the smaller the amount of outside money required to fund net settlement debits. (Spahr [1926], pp. 96-97; Harding [1925], p. 55) Of course, the Reserve banks settled transactions on a gross basis, so the analogy was not entirely apt.

The other basis for seeking to consolidate nationwide check collection was that banks would save the cost of maintaining balances for clearing purposes at correspondent banks. (Board Annual Report [1916], p. 28; Warburg [1930], p 729) Moreover, network externalities were perceived to reinforce the natural monopoly by discouraging participation in a Reserve bank collection system that was anything less than universal. Social welfare would be improved if everyone would use a monopoly clearing house.

The trouble with the Board’s arguments and actions to promote universal par collection of checks was not necessarily with its rationale. It may well have been that mandatory par remittance to a central bank check collection monopoly would have reaped the benefits of economies of scale and network externalities. The upshot of the Board’s campaign to approximate mandatory par remittance, however, was that some states passed legislation to protect non-par banks against Reserve bank actions to compel par payment. Moreover, in response to legal actions taken against Reserve banks, the federal courts ruled that a universal par check collection system was not the intention of the

⁸ The alternative point of view is that both the Congress and the Board intended all along to use the Reserve banks’ *check collection* service (as distinguished from their par interbank ‘exchange’ service) to correct faults in the payments system. (Gilbert 1997) Walter Wyatt, sometime General Counsel of the Board of Governors, provides a reasonably balanced review of the politico-legal basis for these alternative interpretations. (Wyatt 1944)

legislation setting up the Reserve banks. In the relevant Supreme Court opinion, Mr. Justice Brandeis, writing for the majority, found that “there is nothing in the original act or in any amendment from which [a duty to establish a universal par clearance and collection of checks] may be inferred ... Since the Federal Reserve banks cannot pay [remittance fees] they cannot clear or collect checks on banks demanding such payments from them.” (quoted in Harding [1925]) Or, as a lower court judge opined in another case involving non-member banks that objected to being rushed into par banking, “It is one of the inalienable rights of a person to be unprogressive, selfish, and even mean. No other person has the right to coerce him into being otherwise.” (quoted in Murchison [1923]) If non-member banks wanted to collect remittance fees, they were free to do so. By 1924, the System had to abandon universal par collection as an objective for the Reserve banks.

Why did Non par banking persist?

If competition works, why did non-par banking persist for half century after the Board abandoned its campaign for universal par collection? Most accounts of the par collection controversy ignore this question, concerned only with describing the ‘romance’ of the Board’s campaign, constituents’ counter campaigns, and Court decisions. That story ended in 1924, when the Board concluded the campaign by rewriting its Regulation J. From then on, Reserve banks were not permitted to accept checks drawn on non-par banks, regardless whether the checks could be collected at par by presentment over the counter either directly or by using nearby banks as agents.⁹

Previous writers have speculated about whether, after the Supreme Court ended the Board’s campaign to develop a universal par check collection system, market competition alone might have driven non par banking out of existence, just as the

⁹ From the institutional perspective, the non-par story did have one more chapter, the ‘absorption of exchange’ controversy. Briefly, the Banking Act of 1933 forbade member banks from paying interest on demand deposits, which the Board of Governors interpreted to include implicit interest in the form of remittance fees (“exchange charges”) absorbed by a collecting bank. The Banking Act of 1935 extended the prohibition to insured nonmember banks, but the Federal Deposit Insurance Corporation did not consider absorption of exchange a violation of the prohibition. Legislation to resolve the issue was introduced in Congress in 1943, but did not pass. Eventually, the Board ruled that member banks were in

Governors initially had expected. (Spahr [1926]; Jessup [1967]) Indeed, in hindsight, the fundamental economic question remains how non-par banking was able to survive in a market from which exchange charges had been eliminated. To use Carter Glass' vivid analogy, how could non par banks continue to collect tolls for the long distance transfer of funds once the Federal Reserve banks were providing a toll-free nationwide highway system for interbank funds transfers?

The facts of the matter are clear. (See Chart 1) Elimination of exchange charges and the Board's ensuing campaign seem to have been quite successful in eliminating non-par banking for the duration of the campaign. The statistics on par and non-par banks show that non-par banks declined from 43.5% of all banks in 1918 to 6% in 1920. This undoubtedly overstates the success of the Board's campaign, however, for the data are drawn from the Board's own Par List. This was the list of banks whose checks were accepted by the Reserve banks for par collection. It is well known that the Reserve banks collected at par from a number of banks that, if given a choice in the matter, had no intention of remitting at par. The Reserve banks claimed them as par banks because their checks were being presented, or would be presented if ever deposited, over the counter, either by a Reserve bank or a local bank acting as the Reserve bank's agent. (Spahr [1926], p. 577, ft. nt. 59) For example, "...the Federal Reserve bank of New York announced, on March 17, that after April 1, 1917, it would include on its par list the 114 banks in that district which were not remitting at par. The New York Bank expressed the hope that it would not be necessary to resort to forceful methods, such as presentation of checks by express companies, to make collections. This announcement aroused a storm of protest." (Tippetts [1929], p. 271)

After this seemingly effective beginning, however, the reported number of non par banks increased by about 100% between 1920 and 1925, reflecting the combination of more forthright reporting on the Par List and less strenuous attempts at par collection by the Reserve banks. After that, the number of non-par banks declined over many years, to eventual extinction. Nonetheless, despite their decreasing numbers, non-par banks

violation of the law if they absorbed exchange charges in excess of \$2 per month per account. Non member banks had no such limitation. (Jessup, 1967, 14-18; Hackley, 1944)

steadily increased as a percent of all banks in the United States through 1942, because the total number of banks declined even more rapidly than the number of non-par banks.

Focusing on the number of banks, rather than on bank assets or deposits, or customer checks written, undoubtedly overstates the degree to which non-par banking persisted both during and after the Board's campaign. Unfortunately, information about the deposit or asset size of non-par banks is scarce. One glimpse is from 1939, when non-par banks represented 18% of the number of banks in the nation, but held only 2% of the total deposits of all banks. (Banking and Monetary Statistics [1976]) Twenty five years later, in 1964, non par banks were only 10% of the total of all banks, but still held 2% of total deposits. Excluding states without non-par banks, 27% of banks were non-par, but held only 7% of deposits. (Jessup [1967]) Clearly, non-par banking was not a formidable presence in the decades after the Board abandoned its campaign for universal par collection. Nonetheless, the fact that it did not disappear in the face of competition from par banks requires explanation.

The persistence of non-par banking can be explained readily. Non par banking could not have survived in competitive markets, but non-par banks did not operate in competitive markets. Research studies documented this finding long ago, as two studies demonstrate. One was a case study of the state of North Carolina; the other was a national study, using a unique national data set collected by the FDIC in 1964. (Kreps [1957]; Jessup [1967]). The methodology of both studies involved empirical measures of the characteristics of non-par banks. Kreps found that the non par banks of North Carolina were on average smaller than other banks, were situated in smaller towns, and, in 87% of the cases, were not located in the same town as a par bank. Similarly, Jessup found that, for the nation as a whole, non par banks were small, situated in small towns, with 77% located in one bank towns and another 18% in towns with only non par banking competition.

Isolation of non-par banks from par bank competition had a number of dimensions. Local customers lacked an effective choice between par and non par banks: 87% of the non par banks in North Carolina in 1957, and 95% of non par banks in the

nation in 1964 apparently faced no directly visible, local competition from par banking institutions. Remittance fees on checks written by local customers surely would have been an annoyance to out of town payees, had they been aware of them. However, payees tended to be insulated by the “absorption of exchange” by correspondent banks. Of course, correspondent banks would have been aware of the remittance fees they were absorbing. Apparently the small dollar amounts involved did not lead to concerted pressure on non-par banks, probably because checks drawn on non par banks would have represented only a minor component of the collection business of most correspondents. Finally, it appears that non par banks themselves typically insulated their own customers from awareness of remittance fees by absorbing fees on any non par items their customers deposited. (Jessup [1967], p. 86)

It is true that, despite their apparent competitive isolation, non-par banks eventually did disappear. In general, despite any monopoly rents they might have extracted in the market for demand deposits, non par banks were not notably more profitable than par banks. They tended to hold more cash assets than similarly situated par banks, presumably to support correspondent relationships, and had lower revenues from loans, suggesting that remittance fees enabled non par banks to stay in business longer than comparable par banks. Certainly geographical isolation was breaking down over the course of this century, reflecting the impact of innovations in transportation as well as the spread of a growing population. Simultaneously, innovations in communication have depreciated the value of geographical isolation. What the Board’s campaign could not bring about immediately, competition within a changing landscape of banking gradually accomplished.

Conclusions

The Federal Reserve experience with non-par banking can be useful in thinking about Reserve banks’ payments services issues now and in the future. Foremost, it highlights the importance of distinguishing between the social policy role of the System and the payments services business of the Reserve banks. The social policy focus in the case of non-par banking, as in all other cases, should have been with the degree of competition in the markets for interbank payments services and with the rules for access

to Reserve banks' services. Robust market competition ensures the least costly distribution of the benefits of access to the central bank's monopoly over risk-free settlement of payments. Active competition among correspondent banks made universal par check collection inevitable, once exchange charges had been eliminated by giving member banks access to the settlement service of a common central bank money. Rather than waiting for competitive forces to transmit par wholesale payments through into par retail payments, impatient policy makers tried to use Reserve bank check collection services to achieve the expected result directly and immediately. The absence of competition, however, falls within the provenance of the Department of Justice in the United States. Central bank policy must decide whether to cede this ground to the Anti Trust Division, or to develop independent standards and criteria of competition and, if so, on what statutory basis that independent judgment might be founded and implemented.

Might the business role of the Reserve banks be used as a tool of System social policy, to influence the degree of competition in markets for payments services? Clearly, the expected result of the Federal Reserve Act was a change in the competitive nature of markets. The policy goal was that Reserve bank services would "glue" banks to the new central bank; the necessary result was that the Reserve banks would take over a significant share of the then-existing market for correspondent banking services. Of course, the business role failed fully to achieve either the policy goal or its necessary result. It took the statutory changes embodied in the Monetary Control Act to achieve the equivalent of universal reserve requirements and access to services.

Access to Reserve bank base money is the other of the twin foci of payments system social policy. Of course, everyone, from lowly individual to mighty corporation, now has access to base money in its currency form. The serious policy questions must deal with who should have direct access to a deposit account at a Reserve bank. The future seems likely to raise issues of access, as non banks are perceived to have interests in developing new payment technologies, and as banks become affiliated with non bank financial corporations. Access is largely a statutory matter, but one in which the Federal Reserve has standing from which to urge, or to caution against, change, just as the Board did in 1916 and 1917 with respect to check collection for and from non member banks.

Implications of the non-par banking episode for the business focus of the Reserve banks are less readily drawn. Since the Monetary Control Act, Reserve banks have focused on making a business case, not on following social policy instructions, for product design and pricing decisions. This is a fundamental change from 1913 through 1980, when services mainly were a tool for seeking membership goals of the social policy makers of the System. Now, only profitable services support the policy role, directly, by keeping the Reserve banks in touch with banking and financial markets.

If actual or potential competition in markets for payments services is robust, the Reserve banks must be as robust as their competitors. Otherwise, they must withdraw from the market unless policymakers determine that subsidies are justified. Survival in robustly competitive markets requires both efficiency and innovation. Whether innovation comes as a leader or follower in the industry may be a legitimate business decision or a subsidized policy imperative. In any case, another campaign like the Board's futile five-year campaign against the tag ends of non-par banking would be hard to repeat. It would have equal difficulty showing a profit and withstanding the public scrutiny attached to an explicit subsidy.

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